MARKHAM

Report to: General Committee Meeting Date: Feb 4, 2019

SUBJECT: 2018 Investment Performance Review
PREPARED BY: Mark Visser, Senior Manager, Financial Strategy & Investments x.4260

RECOMMENDATION:

1) THAT the reports dated February 4, 2019 entitled "2018 Investment Performance Review" be received;

2) AND THAT staff be directed to update the Development Charges Borrowing Policy and the Investment Interest Allocation Policy to reflect that all internal lending to the Development Charges Reserve will be at the Prime Rate for borrowing deemed to be less than 5 years in duration, and at the York Region debenture rate when borrowing is deemed to be over five years in duration;

3) AND THAT staff be authorized and directed to do all things necessary to give effect to this resolution.

EXECUTIVE SUMMARY:
Not applicable

PURPOSE:
Pursuant to Regulation 438/97 Section 8, the Municipal Act requires the Treasurer to "prepare and provide to the Council, each year or more frequently as specified by Council, an investment report".

The investment report shall contain,

(a) a statement about the performance of the portfolio of investments of the municipality during the period covered by the report;

(b) a description of the estimated portion of the total investments of a municipality that are invested in its own long-term and short-term securities to the total investment of the municipality and a description of the change, if any, in that estimated proportion since the previous year's report;

(c) a statement by the Treasurer as to whether or not, in his opinion, all investments were made in accordance with the investment policies and goals adopted by the municipality;

(d) a record of the date of each transaction in or disposal of its own securities, including a statement of the purchase and sale price of each security;

(e) such other information that the Council may require or that, in the opinion of the Treasurer, should be included.

BACKGROUND:

For the year ending December 31, 2018, the City of Markham's Income Earned on Investments was $13.317 million, compared to a budget of $10.350 million, representing a $2.967 million favourable variance.

The 2018 budget assumed an average general fund portfolio balance of $400.0 million to be invested at an average rate of return of 2.59%. Both the actual average portfolio balance and the average rate of return were higher than the budgeted levels. The details of these two factors will be discussed below.

Interest Rate

At the beginning of the year, the Prime Rate was at 3.20%. The Bank of Canada made three 25 basis point increases in January, July, and October. Although these increases helped Markham's returns in the money market, there was very little sustained impact on long term bond rates. For example, 10 year Canada bond rates were 2.05% at the beginning of 2018 and were under 2.00% at the end of 2018. Markham's weighted average days to maturity decreased significantly in 2018 as there was little incentive to invest long term.

In 2018, the City's investments had an average rate of return of 3.12%, 53 basis points higher than the forecast. The difference in the rate of return accounts for a favourable variance of $2.283 million.

Portfolio Balance

The budgeted average portfolio balance for 2018 was $400.0 million. The actual average general fund portfolio balance (including cash balances) for 2018 was $426.5 million. The higher portfolio balance accounts for a favourable variance of $0.684 million.

Variance Summary

	Budget	Actual	Variance
Portfolio Balance	$400.0m	$426.5m	$26.5m
Interest Rate	2.59%	3.12%	0.53%
Investment Income	$10.350m	$13.317m	**$2.967m**
Portfolio Balance Variance Impact			**$0.684m**
Interest Rate Variance Impact			**$2.283m**

Portfolio Composition

All investments made in 2018 adhered to the City of Markham Investment Policy. At December 31, 2018, 41% of the City's marketable securities portfolio was comprised of government issued securities and 59% of the portfolio was made up of instruments issued by Schedule A Banks. All of these levels are within the targets established in the City's Investment Policy. (Exhibit 1).

The December 31, 2018 marketable securities portfolio was comprised of the following instruments: Bonds 53%; GICs 18%; and Principal Protected Notes 29%. (Exhibit 2)

At December 31, 2018, the City's portfolio balance (all funds excluding Development Charges) of $360.9 million was broken down into the following investment terms (Exhibit 3):

	2018	2017
Under 1 month	35.7%	6.6%
1 month to 3 months	3.9%	20.1%
3 months to 1 year	17.6%	19.4%
Over 1 year	42.7%	53.8%
Weighted average investment term	1,893 days	2,337 days
Weighted average days to maturity	1,044 days	1,310 days

Money Market Performance

The City of Markham uses the 3-month T-bill rates to gauge the performance of investments in the money market. The average 3-month T-bill rate for 2018 was 1.38% (source: Bank of Canada). Non-DCA Fund money market investments held by the City of Markham in 2018 (including bank balances) had an average return of 1.99%. Therefore, the City's money market investments outperformed 3-month T-Bills by 61 basis points. See Exhibit 4 for all Money Market securities held by the City of Markham in 2018.

Bond Market Performance

At December 31, 2018, the City held 34 bonds in the general fund portfolio. The amortized value of these bonds at year-end was $143.8 million. The market value of these bonds at December 31, 2018 was $144.7 million. This translates into $0.9 million of unrealized gains at year end.

Principal Protected Notes (PPNs)

Principal Protect Notes are a relatively new form of investment and are a safe way for municipalities to participate in the equity market. PPNs are notes of indebtedness issued by a bank, which provide a return profile based on an index (i.e. the TSX Low-Volatility index) or basket of equities without requiring direct ownership in the underlying indexes or equities (the underlying holdings are owned by the issuing bank). PPNs are fixed-income securities that guarantee a minimum return equal to the investor's initial investment if held to maturity. In other words, the principal is protected and the City can never lose its initial investment amount.

PPNs often have a low (or no) annual interest component. However, the upside can be quite significant depending on the "participation rate". The participation rate is percentage that the PPN holder receives compared to the overall increase of the underlying indexes or equities. For example, if a $5 million PPN has a 60% participation rate, that means if the underlying index increased by 50% over the duration of the investment, the holder would receive $6.5 million upon maturity, for a $1.5 million net gain [calculated as: $5 million * (1+ (50% increase * 60% participation rate))].

The participation rate is often determined based on a function of duration and annual coupon payments (i.e. the guaranteed interest amount). The lower the coupon and longer the duration of the note, the higher the participation rate. The highest participation rate of a PPN owned by Markham is 350%.

At December 31, 2018, the City owned 12 PPNs with a combined face value of $69.0 million. The market value of these PPNs at December 31, 2017 was $65.7 million. This translates into $3.3 million of unrealized gains at year end. Note: these are unrealized losses only. If held to maturity, the City will not lose any of its principal invested.

Equity markets saw a significant short term drop at the end of 2018 which impacted the market value of the City's Principal Protected Notes (PPN) holdings. The below chart shows the performance of the S&P/TSX Composite Index from January 2018 to January 2019:

The chart clearly shows a significant drop at the very end of December, which resulted in the unrealized losses on the PPNs. In January, the market has already rebounded approximately 10% from its low point near the end of December. As of January 24, 2019, the market value of the City's PPNs have increased approximately $2.0 million since December 21, 2018.

See Exhibit 5 for all 2018 Bond/PPN transactions and holdings.

Reserve Funds and Other Interest

The following table outlines the interest earned on investments for all major City funds and reserves.

	Average Balance	Interest Earned	Average Rate
General Portfolio	$426,500,000	$13,317,000	3.12%
Reserve Funds (+ve balances)	$228,400,000	$4,543,000	1.99%
Reserve Funds (-ve balances)	($188,500,000)	($6,796,000)	3.61%
Trust Funds	$2,440,000	$67,000	2.75%
Powerstream Promissory Note	$67,900,000	$2,994,000	4.41%
MEC/District Energy Loans	$16,800,000	$872,000	5.19%
Development Charge Reserves	$13,900,000	($37,000)	(0.27%)

Because of the large swing in portfolio balances throughout the year (due to the timing of the collection and disbursement of taxes), there will always need to be a significant portion of the City's funds invested in the money market.

The negative rate of return on the reserve funds is a combination of two factors:

1) The City's Interest Allocation Policy (as approved by Council) stipulates that money market rates be allocated to the interest bearing reserves and bond interest be allocated to the general portfolio. The reasons for this are 1) over the long term, bond rates generally outperform money market rates, therefore the City is able to achieve higher rates of return in its general portfolio and thereby reducing the immediate need for tax increases; 2) bond market rates are more stable which allows for smoother budgeting; and 3) reserves and reserve funds can more easily absorb these money market rate fluctuations as the requirements for these funds are longer term in nature.
2) The Interest Allocation Policy also stipulates that "any reserves or reserve funds with negative balances will be charged at a rate of prime.

The $188.5 million of interest bearing reserves with a negative balance were charged $6.796 million of interest (average interest rate of 3.61%). Note: a negative rate of return simply means that the general portfolio is earning a return by "lending" funds to reserves in a negative balance.

The average rate earned for the Development Charge Reserves is also negative as the general portfolio "loaned" $20 million to the DC Reserves from January 1 to August 1, and another $20 million from February 22 to August 1 at a rate of prime since the reserves would have been in a negative position otherwise. As of August 1, there has been no DC borrowing.

OPTIONS/ DISCUSSION:
Outlook
As the yield curve is fairly flat at the moment, there is little incentive to invest in long duration bonds. The strategy in 2019 will be to keep new investments to shorter durations, except with PPNs where there are incentives of greater participation rates for longer durations. The City still has approximately $170 million in bonds and PPNs locked in past 2019 at generally favourable interest and participation rates, and will continue to search for opportunities to buy and sell when deemed in the best interests of the Markham.

The 2019 investment income forecast is expected to be approximately $13 million to $14 million. The budget is set at $11 million as that is considered to be a minimum level that will be sustainable in the long term. Any interest income earned over the $11 million budget in 2019 will be transferred to reserves at the end of the year.

Housekeeping
As part of the Auditor General's Development Charges audit performed by MNP in 2018, they recommended changes to the Development Charge Borrowing Policy and Investment Interest Allocation Policy to ensure consistency and alignment with City practices.

The City has two policies which address reserves and interest rates:

Development Charge Borrowing Policy; and,
Investment Interest Allocation Policy

The Development Charge Borrowing Policy states:

"Internal Borrowing Interest Rate - The internal borrowing rate will be based on the York Region debenture rate for a similar term as the internal borrowing is estimated to be required."

The Investment Interest Allocation Policy states:

"Interest Bearing Reserves and Reserve Funds - Interest is calculated and allocated monthly. The amount of interest is determined by applying the average money market rate earned by the City in a given month to the previous month's ending reserve balance. Any reserves or reserve funds with negative balances will be charged at a rate of prime."

Staff's practice has been to charge the prime rate when development charge borrowing is deemed to be short-term and the York Region debenture rate when borrowing is deemed to be long-term.

To date, all development charge borrowing has been deemed short-term and therefore the prime rate as per the Investment Interest Allocation Policy has been charged. As of August 1, 2018, there is no development charge borrowing.

KMPG recommended updating the policies to be consistent with the above approach.

Therefore, it is recommended that staff be directed to update the Development Charges Borrowing Policy and the Investment Interest Allocation Policy to reflect that all internal lending to the Development Charges Reserve will be at the prime rate for borrowing deemed to be less than 5 years in duration and at the York Region debenture rate when borrowing is deemed to be over five years in duration.

FINANCIAL CONSIDERATIONS
Not applicable

HUMAN RESOURCES CONSIDERATIONS
Not applicable

ALIGNMENT WITH STRATEGIC PRIORITIES:
Not applicable

BUSINESS UNITS CONSULTED AND AFFECTED:
Not applicable

RECOMMENDED BY:

2019-01-28

X Joel Lustig

Joel Lustig
Treasurer
Signed by: cxa

2019-01-28

X Trinela Cane

Trinela Cane
Commissioner, Corporate Services
Signed by: cxa

ATTACHMENTS:
Attachment 1:
- Exhibit 1 – Investment Portfolio by Issuer
- Exhibit 2 – Investment Portfolio by Instrument
- Exhibit 3 – Investment Terms
- Exhibit 4 – 2018 Money Market Investments
- Exhibit 5 – 2018 Bond Market Investments
- Exhibit 6 – 2018 DCA Fund Investments